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AZ CORP COMMISSION
DOCUMENT CONTROL**BEFORE THE ARIZONA CORPORATION COMMISSION**

IN THE MATTER OF THE
APPLICATION OF FAR WEST WATER
& SEWER COMPANY, AN ARIZONA
CORPORATION, FOR A
DETERMINATION OF THE FAIR
VALUE OF ITS SEWER UTILITY
PLANT AND PROPERTY AND FOR
INCREASES IN ITS RATES AND
CHARGES FOR SEWER UTILITY
SERVICE BASED THEREON.

DOCKET NO: WS-03478A-05-0801

**FAR WEST WATER AND SEWER COMPANY'S
EXCEPTIONS TO RECOMMENDED OPINION AND ORDER****February 8, 2007**Arizona Corporation Commission
DOCKETED**FEB 08 2007**

DOCKETED BY

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1 The Recommended Opinion and Order ("ROO") adopts Staff's position on every
2 issue in dispute between Staff and the Company. The ROO adopts Staff's exact rate base
3 and level of operating expenses. The ROO adopts Staff's capital structure, including all
4 of the debt that Staff proposed be included at Staff's recommended interest rates. The
5 ROO adopts Staff's recommended return on equity. The ROO adopts Staff's revenue
6 requirement to the penny. In that respect, the ROO is truly remarkable.

7 Unfortunately, Staff's position on its adjustments to rate base and operating
8 expenses was not based on credible evidence because Staff's witness failed to conduct a
9 thorough analysis. Staff's recommended capital structure violates the matching principle
10 and results in captive lenders at rates nearly 250 points below prime. Staff's
11 recommended cost of equity is unfair, especially when compared to the ROE's recently
12 recommended by Staff for two other sewer utilities. Staff's recommended revenue
13 requirement deprives the Company of more than \$225,000 of annual revenue.

14 In sum, adoption of the ROO, with its wholesale and uncritical adoption of every
15 Staff recommendation, notwithstanding the evidence before the Commission, would be
16 arbitrary and capricious. Adoption of the ROO would also jeopardize the Company's
17 financial health and threaten its ability to continue with desperately needed improvements
18 to its wastewater treatment system. Consequently, the Company submits these Exceptions
19 to the ROO pursuant to A.A.C. R14-3-110(B).

20 EXCEPTIONS

21 The Commission has discretion to weigh evidence and reach a decision; however,
22 that decision and the process by which it is reached are not without limits and standards.
23 *State ex rel. Corbin v. Arizona Corporation Comm'n*, 143 Ariz. 219, 223-24, 693 P.2d
24 362, 366-67 (App. 1984). In that case, the Arizona Court of Appeals summarized the
25 procedural requirements for setting rates as follows:

26 It is a [proceeding] which carries with it fundamental

1 procedural requirements. There must be a full hearing. There
2 must be evidence adequate to support pertinent and necessary
3 findings of fact. Nothing can be treated as evidence which is
4 not introduced as such. Facts and circumstances which ought
5 to be considered must not be excluded. Facts and
6 circumstances must not be considered which should not
legally influence the conclusion. Findings based on the
evidence must embrace the basic facts which are needed to
sustain the order

7 *Id.* at 224, 693 P.2d at 367, citing *Morgan v. United States*, 298 U.S. 468 (1936). The
8 ROO's indiscriminate adoption of Staff's positions does not meet this standard, nor does it
9 meet the requirement that the Commission's decision not be arbitrary and capricious.

10 **A. Working Capital Allowance**

11 The determination of working capital allowance provides a simple illustration of
12 the ROO's shortcomings. Just two months ago, the Commission approved a *negative*
13 working capital allowance (a deduction from rate base resulting in lower revenue) for
14 Black Mountain Sewer Corporation. See Decision No. 69164 (December 5, 2006) at 6-7.
15 RUCO had proposed negative working capital based on a quasi-formula/lead-lag method,
16 which the Commission recognized was not as accurate as a lead-lag study. *Id.* Yet, in this
17 case, the ROO denies the Company a *positive* working capital allowance, which would
18 increase the revenue requirement by approximately \$15,000. See Company's Final
19 Schedules, filed August 15, 2006 ("Final Schedules") at Schedule B-2. The reason: the
20 Company failed to file a lead-lag study. ROO at 8. Yet, in Decision No. 69164, no lead-
21 lag study was filed.

22 There is no basis to treat regulated utilities in an inconsistent manner on the same
23 issue. That the Commission supposedly required that a lead-lag study be filed in the last
24 rate case for the Company's water division is insufficient. See ROO at 8; Brown SB (Ex.
25
26

1 S-23) at 17.¹ The Company has never had a rate case for its sewer division. ROO at 3.
2 The Company did not prepare a lead-lag study in this case in order to avoid dispute and
3 reduce rate case expense. TR at 338 (Bourassa). Since a lead-lag study is obviously not
4 required to determine working capital in light of Decision No. 69164, the ROO's rejection
5 of such an allowance in this case is arbitrary and capricious.

6 **B. Repairs and Maintenance Expense**

7 The ROO removes \$43,378 from the revenue requirement, concluding that
8 "ratepayers should not be burdened with the costs of treatment system repairs necessitated
9 by faulty system installations." ROO at 10. No reference to the record is provided, and,
10 in fact, this conclusion is not supported by the record.

11 The Company's test year Repairs and Maintenance Expense was \$143,705. See
12 Final Schedules at Brief Schedule C-1, page 1. Staff believed this number to be
13 "abnormal" based on the two prior years, 2002 and 2003. ROO at 9. Staff's witness
14 refused to look at the impact of growth on this expense. In fact, the 2005 level of Repairs
15 and Maintenance Expense, which was \$149,825. Ex. A-8; Brown DT (Ex. S-22) at 20.
16 At trial, Staff's witness, Crystal Brown, was unable to explain the basis for Staff's
17 adjustment. In fact, she first testified that the test year isn't even presumed normal. TR at
18 537 (Brown). When asked again to explain the basis for her recommended adjustment,
19 she expressed confusion between this case and two other sewer utility rate cases where
20
21

22
23 ¹ Citations to the record are made as follows: Citations to a witness' pre-filed testimony
24 are abbreviated using DT, RB, SB and RJ for direct, rebuttal, surrebuttal and rejoinder
25 testimony, respectively, along with the exhibit number. Other hearing exhibits are cited
26 by the hearing exhibit number and, where applicable, by page number, e.g., A-15 at 2.
The hearing transcript is abbreviated as TR followed by page number and the identity of
the testifying witness.

1 "sludge removal" was apparently at issue. TR at 540 (Brown).² Finally, Staff's witness
2 testified that she could not explain the basis for the adjustment because she lacked her
3 work papers. *Id.* at 541 (Brown). This is not substantial evidence; it is not evidence of
4 any kind. The ROO's level of this expense is based largely on levels of expense incurred
5 4 and 5 years before the rates approved in this case will go into effect. This is not proper
6 ratemaking.

7 The ROO's justification of this adjustment on "faulty system installation" is
8 equally disturbing. During the hearing, Staff did not claim that test year Repairs and
9 Maintenance Expense was impacted by "faulty system installation." Brown DT (Ex. S-
10 22) at 20. Staff's witness did not make such a connection at trial, nor did Staff make any
11 adjustment to rate base because of this so-called "faulty system installation." Staff also
12 did not ask any of the Company's witnesses whether "faulty system installation" impacted
13 expense levels. Nor did Staff ask a single question of the Company's witnesses
14 concerning Repairs and Maintenance Expense.

15 Instead, Staff waited until its reply brief, when no opportunity for response by the
16 Company was allowed, to fabricate a connection between expenses and "faulty system
17 installation." Staff Reply BR at 11. Staff did not cite a shred of evidence supporting a
18 connection between "faulty system installation" and Repairs and Maintenance Expense,
19 let alone evidence that the Company did anything improper. *Id.* Nevertheless, the ROO
20 adopted Staff's post-hearing assertion. As a result, the removal of \$43,378 from the
21 revenue requirement is not supported by substantial evidence.

22
23
24 ² Sludge Removal expense is a separate expense from Repairs and Maintenance. *See*
25 Final Schedules at Schedule C-1, page 1. *See also* Staff Final Schedules, dated
26 August 15, 2006, at Surrebuttal Schedule CSB-12. Staff made no adjustment to this
expense.

1 **C. Affiliate Transactions**

2 The ROO adopts Staff's adjustment to remove \$147,545 from rate base, lowering
3 the revenue requirement by approximately \$20,000 annually. This amount represents
4 \$110,000 of overhead and \$37,545 of profit on plant constructions costs paid to an
5 affiliated construction company, H&S Developers. ROO at 5-7. The Company presented
6 evidence that this amount was reasonably included in rate base. Staff presented
7 no evidence to the contrary, nor did Staff present any credible evidence in support of its
8 recommended deduction to rate base.

9 The Company presented evidence that all charges for plant construction were billed
10 by H&S Developers based on the cost of labor and materials plus 18.5%. *See* Ex. S-14;
11 TR at 38-39 (Capestro). However, because of the affiliate relationship, Staff questioned
12 the reasonableness of the overhead and profit. In response, the Company provided all of
13 the labor, material and equipment rates charged by H&S Developers. Bourassa RB (Ex.
14 A-5) at 8-9 and Exhibit 1. The Company also presented evidence of comparable costs
15 charged by two other Yuma firms and the RSMeans cost data handbook. *Id.* at 10-11.
16 H&S Developers competes in the Yuma market, and performs construction work for non-
17 affiliated entities. TR at 123-24 (Capestro). The undisputed evidence in this case shows
18 that the amounts charged by H&S Developers were at or below market. *E.g.*, TR at 29-30
19 (Capestro); Bourassa RB (Ex. A-5) at 11. *See also* TR at 275 (Lee).

20 The ROO dismisses all of this as "general argument." ROO at 6. According to the
21 ROO, the Company was required to provide source documentation to prove the overhead
22 costs. *Id.* The Company satisfied this requirement by providing a breakdown of H&S
23 Developers' overhead costs by year for 2002 through 2005. Ex. A-9. Staff ignored this
24 evidence, as explained by its witness:

25 Q. Let me hand you what's been marked as Exhibit A-9.
26 This is attached to Mr. Bourassa's rebuttal testimony as

1 well. This is an H & S Developers statement of income
2 for the years 2002 through 2005. Do you have that
3 document?

4 A. Yes.

5 Q. Mr. Bourassa attached this document to his rebuttal
6 testimony?

7 A. I don't know.

8 Q. Well, okay. You didn't look at this document before?
9 You've never seen this?

10 A. I looked at hundreds, possibly thousands of documents.
11 I don't particularly recall this one.

12 TR at 567-68 (Brown). Instead, Staff wanted evidence of materials purchased by H&S
13 Developers from a third party, H&S Developers' employees' signed time sheets, and H&S
14 Developers' receipts for payments of group medical, workman's comp, employee
15 benefits, advertising and promotion, rent, utilities. Otherwise, Staff argued, the Company
16 cannot include the contractor's overhead in rate base. *Id.*

17 In short, Staff's witness ignored the evidence submitted by the Company. There is
18 no reason to believe that all of the above evidence Staff claims it missed would have made
19 any difference in Staff's position. According to Staff's witness, the Company and the
20 contractor are one and the same entity, their expenses are intermingled, and the Company
21 exists solely for the purpose of facilitating home sales. *Id.* at 559-61. Again, this is
22 unsupported speculation that is contradicted by the evidence in the record before the
23 Commission. Staff did not contest any of the Company's actual operating expenses,
24 except for the adjustment to Repairs and Maintenance Expenses discussed above. Staff's
25 witness admitted that the Company has its own employees, who handle all of the day-to-
26 day operations, and that the Company was unlikely to build its own plant. *Id.* at 545-46.

1 Staff's witness also admitted that she "assumed" that the affiliated contractor worked only
2 for the Company, a claim that was clearly refuted by witnesses for the Company. *Id.* at
3 574-75. *See also* TR at 124 (Capestro). Staff's witness even admitted that construction
4 companies are expected to incur the types of overheads incurred by H&S Developers, and
5 that such entities need to make a profit to stay in business. *See also* TR at 546-57
6 (discussing typical construction company cost structures, overhead and profit). But
7 Staff's witness did not think it was critical to look at evidence of the contractor's overhead
8 costs. Instead, she testified that H&S Developers did not have any overhead. TR at 560
9 (Brown).

10 The fact that a contractor and a utility are related entities is an insufficient reason to
11 disallow costs. *See GTE Florida Inc. v. Deason*, 642 So.2d 545 (Fla. 1994); (Florida
12 Supreme Court overruled a decision of the Florida Public Service Commission to adjust
13 certain costs of affiliate transactions, including profit); *Turpen v. Oklahoma Corporation*
14 *Commission*, 769 P. 2d 1309 (Okla. 1989) ("common ownership is not of itself a ground
15 for disregarding agreements with affiliates"). Staff was required to rebut the evidence
16 presented by the Company and to support its adjustment with evidence of its own. *See*,
17 *e.g.*, *Turpen*, 769 P. 2d at 1323; *Central Louisiana Electric Co. v. Louisiana Public*
18 *Service Comm'n*, 373 So.2d 123, 127 (Before the regulatory body can make adjustments
19 for unreasonably high charges "there must be . . . a factual finding, or at least a reasonable
20 inference, that the charges are unreasonable."). Staff failed to meet this burden and its
21 adjustment to rate base should be rejected.

22 There would be little reason for the affiliated contractor to build plant for the
23 Company in the future if the ROO is adopted. The Company and H&S Developers are
24 separate businesses, and there has been significant growth in Yuma. Liu DT (Ex. S-19),
25 Exhibit JWL at 6. If H&S Developers cannot recover its overhead and earn a reasonable
26 profit on construction jobs for its affiliate, it will limit itself to jobs where overhead and

1 profit can be recovered. The Company will then be forced to hire unaffiliated entities that
2 will charge amounts that, at best, include recovery of overhead and profit, and perhaps
3 higher costs for labor and materials. As stated, H&S Developers' rates were shown to be
4 at or below market. TR at 29-30 (Capestro); Bourassa RB (Ex. A-5) at 11. *See also* TR at
5 275 (Lee). There was also evidence as to the difficulty the Company would face finding
6 other qualified contractors in the rapidly growing Yuma area. TR at 69 (Capestro). Given
7 that the Company has more than \$17 million of new sewer plant construction set to begin
8 upon issuance of ADEQ approval, adoption of Staff's adjustment does not bode well for
9 the Company or its ratepayers.

10 **D. Capital Structure, Cost Of Debt And Cost Of Equity**

11 The ROO's acceptance of Staff's capital structure and Staff's cost of both debt and
12 equity results in a substantial reduction in the Company's revenue requirement. There are
13 reasons to reject all of these recommendations by Staff.

14 **1. Capital Structure**

15 There is no debt financing any of the plant in rate base in the test year in this rate
16 case. E.g., TR at 443 (Rigsby), 489 (Irvine). Nevertheless, Staff's recommended capital
17 structure, adopted in the ROO, includes 44 percent debt. ROO at 13. This debt was
18 primarily debt the Commission authorized the Company's water division to incur more
19 than 7 years ago to build a surface water treatment plant so that Colorado River water can
20 be used. Ex. S-10. There was no evidence that the debt was spent on anything but water
21 treatment, and none of the plant financed by the debt was included in rate base. The
22 remaining debt Staff included in the sewer division's capital structure constituted
23 inter-company payables between the Company and H&S Developers — amounts for plant
24 construction that the Company has been unable to pay due to insufficient revenue.
25 *See* ROO at 14. As a result, the ROO's capital structure and rate base are severely
26 mismatched.

1 The ROO's reasons for including all of this debt in the Company's capital structure
2 are not supported by the evidence. For example, the ROO states that the negative
3 covenants in the debt financing the water plant make it "unreasonable to assign the WIFA
4 debt to water ratepayers, but not sewer ratepayers, in determining a capital structure."
5 ROO at 14-15. No evidence of a relationship between these "negative covenants" and
6 capital structure is cited in the ROO. Moreover, the Commission did not include the
7 sewer division's equity in the rates for the water division, and there are substantially more
8 water utility customers than sewer utility customers. In truth, including the water
9 division's seven-year old WIFA loan in the Company's capital structure is merely another
10 means of reducing the Company's revenue requirement. The resulting mismatch is
11 inconsistent with proper ratemaking. *E.g.*, Bourassa RB (Ex. A-5) at 34-35; Bourassa RJ
12 (Ex. A-6) at 20.

13 2. Cost of Debt

14 Staff's selected interest rate is likewise intended to reduce the revenue requirement.
15 The WIFA loan does not belong in the Company's capital structure in this case, so the
16 interest rate on that loan should have no impact on rates. The inter-company payables
17 also do not belong in the Company's capital structure. There is no evidence that H&S
18 Developers is a willing lender, nor should H&S Developers now be penalized for having
19 been forced to carry the cost of the Company's plant on its books as an accounts
20 receivable. If the Commission is going to force H&S Developers to be a captive lender,
21 then the Commission should approve a reasonable interest rate. The 5.8% interest rate
22 recommended by Staff and adopted in the ROO is nearly 250 basis points before the
23 current prime rate, 8.25%.

24 3. Cost of Equity

25 The ROO adopts Staff's recommended cost of equity, 9.3%, again summarily
26 rejecting all of the Company's evidence and arguments. Staff's recommendation was

1 based on inconsistent and illogical positions regarding the Company's capital, and should
2 be rejected by the Commission.

3 First, the mechanical adoption of Staff's recommendation has become a trend. In
4 every recent Commission decision involving relatively large water or wastewater utilities,
5 the testimony and evidence presented by the utility was flatly rejected in favor of Staff's
6 methodology. And Staff's recommended cost of equity ranged between 9.0% and 9.3%,
7 despite the fact that much larger, publicly traded water utilities have been earning equity
8 returns greater than 10% and are projected to earn higher returns in the future. *See, e.g.,*
9 Decision No. 69164 at 25-27; *Arizona Water Company-Eastern Group*, Decision No.
10 66849 (March 22, 2004) at 24 (approving 9.2% ROE), *Arizona-American Water*
11 *Company*, Decision No. 67093 (June 30, 2004) at 31 (approving 9.0% ROE); *Chaparral*
12 *City Water Company*, Decision No. 68176 (September 30, 2005) at 25 (approving 9.3%
13 ROE); *Arizona Water Company-Western Group*, Decision No. 68302 (November 14,
14 2005) at 31 (approving 9.0% ROE).

15 Utilities in these and other cases have argued that Staff's cost of equity models
16 (which use a group of large, publicly traded utilities as proxies) depress the cost of equity,
17 so that it remains around 9.0%, regardless of the publicly traded utilities' actual and
18 projected earnings. *See, e.g.,* Bourassa RB (Ex. A-5) at 52-53; Company BR at 17-19.
19 Boiled down, Staff's methodology relies on inputs and adjustments that ensure the *same*
20 result, regardless of changing financial and economic conditions. *Id.* Thus, when interest
21 rates increase, as they have since mid-2006, Staff's recommendation stays the same.

22 For example, in Black Mountain Sewer Company's ("BMSC") recent rate case,
23 Decision No. 69164, the Commission rejected RUCO's use of a hypothetical capital
24 structure that included 43% debt because that capital structure was "result[] oriented and
25 inconsistent with [BMSC's] actual capital structure." Decision No. 69164 at 20. The
26 Commission also adopted Staff's 9.6% cost of equity because that utility's actual capital

1 structure contained 100% equity and no debt. *Id.* at 26-27. Staff argued, and the
2 Commission agreed, in that case that a lower cost of equity is justified for utilities that
3 have a high percentage of equity in their capital structure, which reduces financial risk.
4 *E.g.*, Chavez DT, Docket No. SW-02361A-05-0657, at 33-34.

5 In Gold Canyon Sewer Company's pending rate case, Docket No. SW-02519A-06-
6 0015, Staff's cost of equity models, again using the same large, publicly traded water
7 utilities as proxies, produced a cost of equity of 10.2%. However, Staff adjusted the cost
8 downward to only 9.2% arguing, again, that the utility's capital structure contains 100%
9 equity and no debt, reducing financial risk. *E.g.*, Irvine DT, Docket No. SW-02519A-06-
10 0015, at 32-33.

11 By contrast, in this case, the ROO adopts Staff's adjusted capital structure,
12 consisting of 56% equity and 44% debt. Based on that capital structure, and based on the
13 BMSC and Gold Canyon rate cases, one would logically expect Staff's cost of equity to
14 exceed 10%. With a capital structure containing 44% debt, the Company has significant
15 financial risk. Nevertheless, Staff recommended, and the ROO adopts, a cost of equity of
16 only 9.3%, only 10 basis above Gold Canyon and, incredibly, 30 basis points *less* than
17 BMSC, which have no debt in their capital structures.

18 In other words, Staff is allowed to have its cake and eat it too. First, Staff used a
19 hypothetical capital structure that includes 44% debt, lowering the overall cost of capital
20 (even though the WIFA loan is known to be financing water treatment plant, not sewer
21 plant). Second, Staff made a downward adjustment to the cost of equity because the
22 Company lacked debt in its capital structure and, therefore, has less financial risk. It
23 would be arbitrary and capricious to impute debt and then ignore that debt in order to
24 lower the overall rate of return. Accordingly, the Commission should reject the ROO's
25 adoption of Staff's 9.3% cost of equity and approve the Company's recommended return
26 on equity of 10.5%.

1 DATED this 8th day of February, 2007.

2 FENNEMORE CRAIG, P.C.

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